Monthly Commentary

August 20, 2012

SELECTOR
Real-Time Money Management

“Good investors gather information, put that information into current and historical context, then make sound decisions.”

The past month has healed a number of technical wounds for equities markets. Leadership is clearly in the large cap domestic equities’ camp. While this continues to be very good for the traditional large cap indexes such as the DJIA and the S&P 500, it is unusual for the ‘generals’ to be leading the charge, especially the small cap ‘enlisted troops.’ More on this later, as we note our short list of worrisome indicators for equity markets. But back to the good news. Real estate equities continue to demonstrate excellent relative strength, as does health care and technology. We monitor a number of key technical indicators which include moving averages, trendlines, and support/resistance levels. In addition, we watch momentum oscillators such as stochastics and relative strength data. Finally, we pay attention to some of the old-school traditional data like relative volume. For almost every major indicator we follow we are getting green lights.

That being said, there are a few things that we are watching carefully. First, the small cap indexes are not rising with the same robustness as the large caps. This tells us that institutional investors are still not fully embracing this equity market. If they were, they would be making more ‘risk on’ transactions into the small cap sector. Second, the Volatility Index, also known as the VIX, is near record lows. The VIX is commonly called the ‘Fear Index’ and is a complicated mathematical derivative reported as an annualized standard deviation and designed to predict implied volatility of the S&P 500 over the next thirty days. The higher the VIX, the more perceived market risk. The last time we saw VIX numbers this low was mid-March of 2012. By the end of May the VIX had shot up as high as 27.73 while equities dropped more than 10%. (That still pales in comparison to August-October of 2011 when the VIX was in the upper 40’s. and markets were in 15-20% corrections.) Historically, a low VIX doesn’t spell immediate danger. Equity markets went to annual highs on April 1st and approached those highs again on May 1st. That was two and six weeks later.

Bond markets are now in their fourth week of a correction from their July yearly highs. The move lower coincided almost perfectly with the equity markets’ recent push higher, especially when comparing the government bond markets. This has been a mild correction for the broad bond markets, with the Barclays Aggregate Bond Index now down less than -2% from its recent yearly high and up +2.41% YTD. TIPs have declined slightly more, with the Barclays TIPS Bond Index now down by -2.6% from its recent high for the year, yet still up +3.44% YTD. The much more volatile long term government bonds are down considerably more, with the Barclays 20+ Year Treasury Bond Index now -8.6% off its recent highs, but still up +2.11% YTD.

Portfolio adjustments were made the end of July that better aligned managed portfolios with leadership sectors. These include large cap domestic equities, real estate, and health sciences. There was relatively good performance in these sectors across a large population of mutual fund and variable annuity subaccount managers. The next level focused on midcap and small cap domestic equities, which exhibited a broad variation in performance depending upon the managers. Underperforming midcap and small cap holdings were replaced. Better performing holdings in these sectors were retained. The final level of portfolio positions were those which held natural resources and emerging markets securities. These were the best performers the first five months of 2012, only to become sharply oversold in the May correction. They have since demonstrated very positive relative strength and we have chosen to continue to hold these sectors.

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We feel that the next few weeks will be pivotal for financial markets, potentially signaling the last significant move until the dust settles after the November elections. An interesting recent development is how the major market equity indexes have been tip-toeing back to their previous yearly highs. With our current allocations we are obviously weighted on the side of higher prices. Should the momentum change, you may anticipate quick adjustments towards the safety of bond markets. **SELECTOR®** Aggressive Growth and Growth models are currently 100% invested in domestic and international equities. **SELECTOR®** Conservative Growth models are now 80% equities/20% bonds, while **SELECTOR®** Balanced Growth models are now 60% domestic and international equities/40% bonds. **SELECTOR®** Income & Growth models are 40% equities/60% bonds, and **SELECTOR®** Income models are 100% invested in bonds.

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Sources: Barrons, Bloomberg, iShares.com, Marketwatch.com, Stock Trader’s Almanac 2011, StockCharts.com.